OFFICES OF THE COUNTY EXECUTIVE

Douglas M. Duncan
County Executive

Bruce Romer
Chief Administrative Officer

August 15, 2005

Members of the Montgomery County Council

I am pleased to present to you the Quarterly Report of the Montgomery County Employees' Retirement System ("ERS") for the quarter ended June 30, 2005. This quarterly report is designed to assist you in understanding the current status of the ERS. This report was prepared pursuant to the provisions of Section 33-51(a)(4) of the Montgomery County Code of 1994, as amended.

History

The Employees' Retirement System was established in 1965 as a cost-sharing multiple-employer defined benefit pension plan providing benefits to the employees of Montgomery County and other agencies or political subdivisions who elect to participate. In addition to Montgomery County Government, participating agencies and subdivisions include the Montgomery County Revenue Authority, Housing Opportunities Commission of Montgomery County, independent fire/rescue corporations, Town of Chevy Chase, Strathmore Hall Foundation, Inc., Washington Suburban Transit Commission, and certain employees of the State Department of Assessments and Taxation and the District Court of Maryland. The System is closed to employees hired on or after October 1, 1994, except public safety bargaining unit employees. There were 5,396 active members and 4,467 retirees participating in the ERS as of June 30, 2005.

Performance Results

The total return achieved by the ERS assets for the quarter was 2.37%, slightly better than the benchmark index return of 2.25%. For the one year period ending June 30, the ERS' gross return (before fees) was 10.54%, 85 bpts. above the benchmark index return of 9.69%. The strong one-year return places the ERS' performance in the top 25% of a universe of public pension funds constructed by the Board's consultant, Wilshire Associates. For the three-year period, our performance was 10.45%, after fees, ranking in the top 14% of the universe. The asset allocation at June 30, 2005 was: Domestic Equities 49.7%, International Equities 15.3%, Fixed Income 24.7%, TIPS 9.1%, Alternative Investments 1.0% and Cash .2%.

Major Initiatives

During the quarter, the Board expanded its investments in the alternatives sector by hiring a secondary fund-of-funds manager. The Board now has $150 million committed to the sector and will be looking to make additional investments in the coming year.

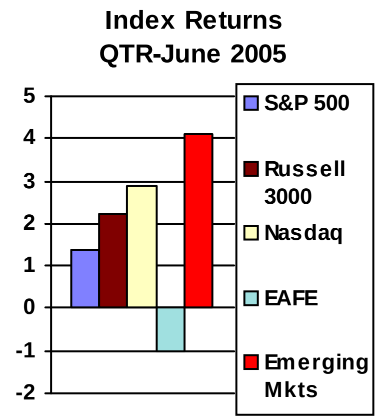
The Board received its annual review of brokerage fees paid by the ERS equity managers. Overall the Plan's total average commision rate (expressed in cents per share) ranked in the top quartile (better than 75% of the other plans) in a national universe. Our domestic trading costs were 18% lower in 2004 versus 2003's rate. The Plan's 2004 fees, including administrative and investment management fees, were 6% lower than those reported in a national consultant's survey.

In addition, the Board expanded its Risk Management Program to include: analysis of how possible economic and market events might impact the portfolio, also known as the value-at-risk measure: further development of reporting on derivative holdings and their contribution to duration: and construction of a risk budget which evaluates the risk/ return contribution from each manager and asset class.

Capital Markets and Economic Conditions

As expected, the Federal Reserve raised the Fed Funds rate for the ninth consecutive time at the June 29th meeting to 3.25%, with a statement emphasizing that inflation pressures remain elevated. This strongly suggests that the tightening process is likely to continue through the next quarter. The Fed would like to see higher long-term rates which would cool down the real estate market. The Federal Reserve is concerned about froth in home prices in certain sectors of the country. The problem is that as low as our rates seem to be, they are higher than those in other developed economies and as such capital is being drawn to our bond market. Currency moves overshadowed stock and bond returns for the quarter as the U.S. dollar gained 7% against the euro and 4% against the Japanese yen. The strength of the dollar resulted in negative returns for U.S. investors in most world markets with the exception of emerging markets.

As shown in the chart to the right, after a very weak April, the U.S. equity markets moved higher in May and June ending the quarter with the broad indices, like the Russell 3000, up around 2%. Stocks were supported by the ongoing bond rally as long-term bond yields declined despite rising short-term interest rates. Small stocks did the best during the quarter, advancing 4%, as measured by the Russell 2000 Index. Strong gains came from the utilities sector, where debt reduction, capital improvements, and increasing demand for power have helped earnings, and healthy dividend yields have attracted investors. Stocks within the materials sector fell as investors worried about demand, prices for metals and raw materials declined, and bulk shipping rates dropped sharply. The ISM manufacturing index declined in April and May, indicating that the expansion in the manufacturing economy had slowed, but reaccelerated in June. Our combined domestic equity performance was a gain of 2.7% for the quarter, beating the 2.2% return recorded by the Russell 3000 benchmark index. For the one-year period ending June 30, our combined performance is 9.8%, over 100 basis points ahead of the benchmark.



Within Europe, despite weak domestic economies and political turbulence in the region, European equity markets rose in local currencies, and had some of the best returns among developed equity markets. Emerging markets posted the strongest performance for the quarter, up 4.1% in U.S. dollar terms. Among the larger Asian markets, Taiwan and China had gains in the mid-single digits and Indian stocks rose sharply. Due to the strength of the dollar, our international equity performance was a loss of .28% for the quarter compared to the System's benchmark index loss of .01%.

Fixed income markets experienced a further flattening of the yield curve with the difference between the two-year and 10-year Treasury yields moving from 70 basis points to 28 basis points by quarter end. Our combined fixed income return for the quarter was a gain of 3.06% compared to the 2.94% gain recorded by the benchmark index. The outperformance against the benchmark was due to the 4.8% return from the high yield bond portfolio.ERS investments in Treasury Inflation Protection Securities (TIPS) recorded a gain of 3.22% for the quarter.

Additions

The primary sources of additions for the ERS include member and employer contributions and investment income. The following tables show the source and amount of additions for the quarter ending June 30, 2005 and fiscal year-to-date.

Employees' Retirement System
Contributions and Investment Income
(millions)

	Qtr 6/30/05	Fiscal YTD
Employer Contributions	$ 18.7	$ 74.7
Member Contributions	3.8	15.3
Net Investment Income	47.2	196.8
	$ 69.7	$ 286.8

Deductions

The deductions from the Employees' Retirement System include the payment of retiree and survivor benefits, participant refunds, administrative expenses and other costs.

Employees' Retirement System
Deductions by Type
(millions)

	QTR 6/30/05	Fiscal YTD
Benefits	$ 29.5	$ 115.6
Refunds	.2	.7
Administrative Expenses	.5	2.0
	$ 30.2	$ 118.3

Outlook

With a robust economy, analysts expect the Federal Reserve to continue raising interest rates by 25 basis points at both the August and September meetings to a target level of 3.75%. Because personal income growth is running strong, and the unemployment rate is low and still falling, the consumer should continue to fuel the economy.

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF PLAN NET ASSETS
June 30, 2005

Assets	
Equity in County's pooled cash and investments	$ 544,457
Investments	
Northern Trust	2,130,798,360
Aetna	9,956,105
Fidelity - Elected Officials Plan	697,725
Total investments	2,141,452,190
Contributions receivable	4,867,691
Total assets	2,146,864,338
Liabilities	
Benefits payable and other liabilities	2,720,433
Net assets held in trust for pension benefits	**$ 2,144,143,905**

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET ASSETS
June 30, 2005

Additions	Quarter	Fiscal YTD
Contributions		
Employer	$18,746,369	$74,729,678
Members	3,757,792	15,339,045
Total contributions	22,504,161	90,068,723
Investment income	49,122,263	203,975,855
Less investment expenses	1,927,505	7,209,622
Net investment income	47,194,758	196,766,233
Total additions	69,698,919	286,834,956
Deductions		
Retiree benefits	27,252,549	102,640,097
Disability benefits	2,017,732	10,906,765
Survivor benefits	249,928	2,086,755
Refunds	211,569	709,164
Administrative expenses	482,344	1,967,241
Total deductions	30,214,122	118,310,022
Net increase	39,484,797	168,524,934
Net assets held in trust for pension benefits		
Beginning of period	2,104,659,108	1,975,618,971
End of period	**$2,144,143,905**	**$2,144,143,905**